

STATEMENT OF MARTIN FELDMAN

SALOMON SMITH BARNEY

BEFORE THE SENATE COMMERCE COMMITTEE

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Thank you Chairman McCain, Senator Hollings and other members of the Senate Commerce Committee. I very much appreciate this further opportunity to present my views on the proposed tobacco settlement and would ask that this testimony be considered in conjunction with the testimony I gave last week.

I'm an equity analyst at Salomon Smith Barney with responsibility for coverage of the tobacco sector. My only objective in all of this is to forecast accurately the fortunes of the tobacco companies. I neither support nor oppose any of the participants in this debate. It's simply a case of trying to get the facts right and I am happy to be able to provide the Committee with whatever technical assistance I am able. As an industry analyst, my reputation is reliant on accurate forecasting. Wherever possible, I prefer to use historical information or foreign precedents, rather than relying on abstract forecasts.

Today I will summarize my views of the pricing aspects of the Proposed Resolution, as well as my understanding of the most recent proposals of the Administration.

1) I believe that the Proposed Resolution, meets President Clinton's stated goal for retail cigarette prices to increase by **"up to \$1.50 within 10 years."** By my estimates, within a decade, the cost of a pack of cigarettes might have increased by over \$1.60 or 90% to \$3.48. These are real numbers and assume a 2% inflation rate over the period. In real 1997 dollars, the Proposed Resolution, including maximum lookback penalties as well as upfront payments may have been worth \$421 billion.

1) I understand that the Administration is now seeking to use a rather more costly settlement structure. The actual cost to the industry appears to have increased very sharply, and higher targets are established for reductions in youth consumption. These newest proposals envisage a total settlement value of some \$760 billion which equates to \$421 billion under the original proposals. In order to reach this estimate I have assumed that youth smoking declines in line with a 7% price elasticity of demand. That is a highly

reasonable, if optimistic assumption. By way of example, youth consumption may fall by 51% over fifteen years, yet even then, the industry would still have suffered total lookback penalties of \$79 billion. Of course that is in real terms. On the basis of the method of calculation used by the Treasury, the accumulated lookback penalty, could be \$154 billion.

1) The most critical aspect of any new legislation, must be its impact on retail pricing. Pricing remains a very effective instrument by which to reduce per capita consumption as well as to influence the national smoking incidence. The most significant financial pain that the industry will endure, will likely occur as a result of large reductions in volume demand by adult consumers. Under the Proposed Resolution, I believe that real retail prices will rise (from 1997) by 74% to \$3.17 in year five, and by 91% to \$3.48 in year ten.

Under the Administration's newest proposals, I forecast that the average real retail price, perhaps at a gas station or a convenience store, will rise by 100% to \$3.67 in year five, and by 145% to \$4.46 in year ten. These price increases are dramatic. In my opinion, they may spawn a sizable black market in tobacco products. Remember that cigarettes cost just a dollar a pack in Mexico, and in Canada, are currently priced at around \$2.45. Further, if my assumptions for the rate of decline in youth consumption are too optimistic, then sharply higher lookback penalties could lead to the weaker US manufacturers seeking bankruptcy protection after five years. I would strongly urge this Committee to ensure that any new legislation does not lead to a reduction in the number of US manufacturers, or to an inability by plaintiffs to seek damages from the existing legal entities.

1) I should now like to compare my estimates for retail pricing with those of my friends at the Treasury. Forecasting is not an exact science, and I think that in most respects we do not disagree with each other's assumptions. There are however some important differences and I would stress again, that my only objective is to reach practical and accurate forecasts, capable of being scrutinized. In short, I believe that the Treasury forecasts make retail cigarette prices appear lower than may actually occur. As you may notice, by years ten and fifteen, there is a material difference in our pricing forecasts. On the basis of a 7% youth elasticity, my model concludes that real retail prices may be \$4.46 and \$4.65 respectively. On a comparable basis, I believe that Treasury would reach retail prices of \$4.06 and \$4.07 respectively. The key reasons for my higher retail costs are the following:

i — The industry has entered into binding obligations to settle certain cases (not included in the Proposed Resolution) and to pay plaintiff lawyers \$500 million annually; subject to arbitration.

ii — The industry will likely follow global precedents, and continue to take annual real pricing increases.

iii — Federal excise taxes are likely to grow by at least 10 cents every four years, even after the new legislation.

iv — We believe that wholesale and retail revenues per pack will grow in real terms as volumes decline and the cost of compliance with the new regulations increase.

In conclusion, I would stress those aspects of the proposed resolution that I believe have not yet received sufficiently full attention:

A) Non-financial measures may have a greater impact on reducing teen smoking and the national smoking incidence than price increases alone.

A) One of the key motives behind the June 20 agreement, was to raise substantially the retail price of cigarettes in the US. Both the lookback penalties, and the base settlement costs were expected to be passed on to retail customers—largely in order to use price as an instrument to reduce consumption. Raising revenues for both Federal and State government was at best, a tertiary motive in comparison to altering the conduct of the industry, and growing retail prices on the basis desired by many in the public health arena. Today, those motivations appear to have become blurred by Federal funding requirements. I believe that the markets remain perturbed that such motivations are seriously hampering prospects for successful implementation of new legislation during 1998.

A) It might be helpful to consider that in 1997, US industry net sales, and operating income was about \$21 billion, and \$7.5 billion respectively. In comparison, under our estimate of the Administration's current proposals, by 2008, while overall US volumes might have dropped by 30%, and even if there is a 43% fall in youth consumption, the industry will still be liable for lookback penalties of \$12.3 billion on a real basis, or \$15.2 billion on a nominal basis.

A) I believe that it would be a serious mistake to ignore the fact that the individual tobacco companies would need to sign consent decrees before much of the proposed legislation may be implemented. While this remark may be unpopular, I think that the companies will give very serious consideration to such agreements. If RJR was to perceive that its investment grade status was being threatened, I believe that that might represent an insurmountable hurdle for its board. If any of the smaller companies believed that the legislation might further enhance competitive prospects for one of the larger companies, I think that that too would lead to reluctance to agree to the required consent decrees.

A) Potential bankruptcy is a real possibility for the weaker US manufacturers. It could easily result from some of the legislative proposals currently under consideration, or from a situation, where, despite possibly being in 100% compliance with the new regulations, youth consumption fails to fall as far as the targets envisage. If this occurred it might dilute the ability of the industry's opponents to regulate US tobacco manufacturing as well as to realize damages.

The potential bankruptcy of any US manufacturer would likely hurt tobacco farmers and all domestic economic beneficiaries of the industry. That would achieve none of the public health goals espoused by Mike Moore and the other settling states, and might result simply in a benefit to foreign manufacturers.

Thank you for listening. I am willing to assist the Commerce Committee in any way that I am able.
